

**Testimony of the Honorable Michael M. Reyna
Chairman and Chief Executive Officer
Farm Credit Administration
Before the
Committee on Agriculture, Nutrition, and Forestry
United States Senate
February 26, 2001**

Mr. Chairman, members of the committee, I am Michael Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or Agency). Joining me is my fellow Board member Ann Jorgensen. I am pleased to be here with you today to discuss the role of the FCA and the Farm Credit System (System) in providing sound, dependable, and affordable credit to American farmers and ranchers, their cooperatives, rural utilities, and rural homeowners in both good and bad economic times. I am pleased to report to you that the financial condition of the System is strong despite challenges and difficulties in the agricultural economy. I plan to use this opportunity to explain our proposed regulation concerning national charters for System associations.

FARM CREDIT ADMINISTRATION

The FCA is an independent agency in the Executive branch of the Federal government. It charters, regulates and examines all System institutions. The responsibility of the FCA is to ensure that System institutions operate safely and soundly and comply with applicable laws. The FCA's governing body is a full-time, three-member Board. The President, with the advice and consent of the Senate, appoints each FCA Board member for a six-year term. The President

designates one of the Board members as the Chairman of the Board, who serves until the conclusion of that member's term. The Chairman also serves as the FCA's Chief Executive Officer (CEO).

THE FARM CREDIT SYSTEM

Congress established the System in 1916 because long-term mortgage credit for farmers and ranchers was scarce. During the 1920s and 1930s, Congress expanded the System so it could extend short- and intermediate-term operating credit to farmers and ranchers and finance their cooperatives. Today, the System finances agricultural production, processing and marketing operations, certain farm-related businesses, rural housing, agricultural cooperatives, rural utilities, and the import and export of agricultural commodities. Within the scope of the Farm Credit Act of 1971, as amended (Act), System banks and associations offer their customers a wide array of loans, leases, and financially-related services that meet their needs. According to section 1.1 of the Act, the mission of the System is to "be responsive to the credit needs of all types of agricultural producers having a basis for credit."

The System is the oldest Government-sponsored enterprise (GSE) in the United States. Although the Federal government provided the original capital for System institutions, the farmers, ranchers, and cooperatives who borrowed from System banks and associations retired the government capital by 1968. Today, borrowers own the System banks and associations, which operate as cooperative financial institutions.

System banks, associations, and service corporations serve all 50 States and the Commonwealth of Puerto Rico. As of January 1, 2001, the System was composed of 147 institutions. Six Farm Credit Banks fund 28 production credit associations (PCAs), 38 Federal land credit associations (FLCAs), 11 agricultural credit associations (ACAs), and 52 ACA parent

organizations.¹ PCAs make short- and intermediate-term loans; FLCAs make long-term mortgage loans; and ACAs make short-, intermediate-, and long-term loans. Different System banks and associations own four service corporations that are organized under section 4.25 of the Act. These federally chartered service corporations perform functions and services for their owners, but the statute prohibits them from extending credit and providing insurance services.

The Farm Credit Banks also fund 22 other financing institutions (OFIs), which are non-System financial institutions, such as commercial banks or their affiliates, agricultural credit corporations, and production livestock associations. OFIs use the funds they borrow from Farm Credit Banks to make short- and intermediate-term loans to farmers, ranchers, and other eligible borrowers. The Act allows Farm Credit Banks to fund OFIs on the same terms as PCAs.

One agricultural credit bank (ACB) lends to agricultural and aquatic cooperatives, rural utilities, and the parents, subsidiaries and affiliates of these borrowers. The ACB also finances the export and import of agricultural commodities and farm supplies, and it provides international banking services to agricultural cooperatives and their counterparties. Additionally, the ACB funds four ACA parent organizations that serve New York, New Jersey, and the New England States.

All seven System banks own the Federal Farm Credit Banks Funding Corporation (Funding Corporation), which sells debt securities to investors. The proceeds of these securities fund the loans that System banks and associations make to their borrowers. Earnings from these

¹ The ACA is the parent company with two wholly owned subsidiaries, a PCA and a FLCA. The ACA, PCA, and FLCA operate as an integrated lending business with loans made through the appropriate subsidiary. The ACA, PCA, and FLCA are jointly and severally liable for the full amount of the indebtedness to the bank under the General Financing Agreement. In addition, the three associations agree to guarantee each other's debts and obligations, pledge their respective assets as security for the guarantee, and share each other's capital. The three institutions have a common board and management and a common set of shareholders. Under the Farm Credit Act of 1971, as amended, the FLCA is exempt from Federal income taxes.

loans enable System banks to repay the principal and interest on System debt securities. The United States is not liable for the repayment of System debt securities.

Congress established the Farm Credit System Insurance Corporation (FCSIC) to insure the principal and interest on all consolidated System debt securities. As of December 31, 2000, the FCSIC fund had a balance of \$1.45 billion to protect investors and, ultimately the taxpayers, from loss. Additionally, the Act requires the FCA to appoint FCSIC as the conservator or receiver of insolvent System institutions. My colleague, Ann Jorgensen, serves as the Chair of FCSIC.

The Federal Agricultural Mortgage Corporation (Farmer Mac) is another component of the System.² Farmer Mac provides a secondary market for agricultural real estate and rural housing mortgages.

SERVING YOUNG, BEGINNING, AND SMALL FARMERS

As the Committee is well aware, the agricultural economy is constantly changing and farmers often restructure their operations as they strive to become more efficient. The System cannot succeed unless it responds to changes in the markets that it serves. As I noted earlier, the Act states that the mission of the System is to serve all types of agricultural producers who have a basis for credit. The System finances every sector of the agricultural economy throughout our nation. As the statute requires, it serves all types of producers -- large, medium, and small.

The FCA has made a concerted effort to improve the service that System banks and associations provide to young, beginning, and small farmers. Since 1980, the Act has required the System to develop special programs to meet the credit needs of young, beginning and small

² Farmer Mac has no liability for the debt of other System institutions, and the other System institutions have no liability for Farmer Mac's debts. Farmer Mac is an investor-owned corporation, not a member-owned cooperative. Commercial banks, insurance companies, other financial institutions, and System banks and associations may own

farmers. In 1998, the FCA issued a policy statement that asked each System Board of Directors to renew its commitment to be a reliable, consistent, and constructive lender to this group of farmers. Although the FCA recognized that the System already financed a significant number of young, beginning, and small farmers, the policy statement noted that more could be done. The policy statement identified a number of steps that System institutions could take to increase their lending to this group of customers.

Just recently, the FCA asked each System institution for information on its young, beginning, and small farmer program. The FCA will use this information to compile a report on successful and innovative practices that improve service to these farmers. We plan to send this report to every System institution so the ideas and experience of other institutions will help it to strengthen its own program. This information will help the FCA to identify the strengths and weaknesses of the young, beginning, and small farmer programs of individual System institutions. As a result, the FCA will no longer rely exclusively on numbers that are nationwide averages.

The most recent numbers on loans to young, beginning, and small farmers and ranchers are from year-end 1999. At that time, 16.3 percent of the System's outstanding loans were to farmers who were 35 years of age or younger, 20.7 percent were to beginning farmers with 10 years or less of farming experience, and 57.9 percent were to small farmers who had annual sales of \$250,000 or less. Concurrently, 12.2 percent of the total dollar volume of loans outstanding were to young farmers, 17.9 percent were to beginning farmers, and 34.4 percent were to small farmers.

voting stock in Farmer Mac. The Office of Secondary Market Oversight is a separate office in the Farm Credit Administration that regulates and examines Farmer Mac.

THE CURRENT CONDITION OF THE FARM CREDIT SYSTEM

The System's Strengths

The quality of loan assets, risk-bearing capacity, stable earnings, and capital levels collectively reflect a healthy Farm Credit System that has rebuilt its financial strength and improved its management systems. Despite various external factors affecting agriculture, such as reduced export demand, adverse weather conditions, and low commodity prices, the System's strong financial position will help it weather adverse effects from potential deterioration in the agricultural economy.

System banks and associations have earned and retained sufficient income over the past twelve years to rebuild their capital. For example, since 1994, the System has steadily earned \$1 billion or more each year. This has resulted in a large capital cushion that will enable the System to absorb losses and remain a viable lender to agriculture during downturns in the agricultural economy.

The quality of the System's loan portfolio has remained generally favorable despite continued adverse economic conditions in the agricultural sector and a slight deterioration in the performance of certain loans to cooperatives. Signs of deterioration have yet to materialize in the System's loan portfolio or performance, and early warning indicators are much more positive than in the mid-1980s when the System last experienced serious asset quality problems.

Loan volume continues to grow, while levels of nonaccrual and nonperforming loans³ consistently remain low. Delinquent loans also remain minimal at less than half of one percent of total loans.

³ Nonperforming loans consist of nonaccrual loans, accruing restructured loans, and accruing loans 90 days or more past due.

The System continues to build capital through increased loan volume and earnings. Total capital as a percentage of total assets has increased from 14.2 percent as of September 30, 1996, to 15.6 percent as of September 30, 2000. All institutions met their regulatory ratio requirements, and most greatly exceeded them. Permanent capital ratios at System banks and associations ranged from a low of 9.94 percent to a high of 38.2 percent compared to the 7.0 percent regulatory requirement.

Better management practices have resulted in stronger loan underwriting standards at most System institutions. Improved loan underwriting standards usually results in sound loans. Additionally, these standards insulate an institution's capital from excessive risk in a challenging operating environment.

As a result of improving their management and internal controls, System institutions have been diligent in identifying and dealing with troubled loans early on. Also, improved asset/liability management practices have enabled System banks to effectively manage interest rate risk.

The FCA currently rates all System institutions, except one small association, in the two highest of the five Financial Institutions Rating System (FIRS) categories. As of September 30, 2000, institutions with composite ratings of 1 or 2 represented more than 99 percent of all rated institutions. FCA assigns every System institution a rating for capital, assets, management, earnings, liquidity, and sensitivity to interest rate fluctuations. Every institution receives a composite rating and a rating for each of the six individual rating components at least quarterly to ensure assigned ratings reflect current risk and conditions in the System. Currently, no System institution is under an enforcement action. In addition, our examiners provide

continuous oversight of System institutions to ensure that risk in the System is adequately monitored and addressed.

The Challenges Ahead

Economic stress in agriculture, however, is beginning to temper this good news.

As this Committee knows all too well, prices for many agricultural commodities are low while farm production costs, particularly for energy, are increasing. As a result, the profit margins of many farmers are squeezed. Federal support for agriculture over the past several years have been necessary to help farmers repay their loans. Obviously, farmers, System institutions, and the FCA would much prefer that more favorable commodity prices would generate higher profits and better income for agriculture. In addition to strong capital and diligent management at System banks and associations, Federal assistance to farmers has also played an important role in helping the System earn income and maintain the quality of its loan portfolio.

Two indicators of profitability, net interest margins and net interest spreads, have been trending downward since 1995. ROA has also followed a declining trend for the past six years, but it increased in 2000. Although these downward trends raise concerns, they also stress why retained earnings and strong capital are crucial to the continued financial strength of System institutions.

The allowance for loan losses continues to be adequate to cover risk in the loan portfolios. Since 1993, the System has steadily increased its Allowance for Loan Losses to almost \$2 billion in the past year. This increase is necessary to address the stress in the farm economy. However, nonaccrual loans decreased slightly in the past year.

A Single-Industry Lender

Perhaps the biggest challenge facing the System is the fact that it is a single-industry lender in a shrinking market. The number of farmers and ranchers has steadily declined ever since the System was founded in 1916. However, the System's mission is to finance agriculture in both good and bad economic times. In contrast, the System's competitors can abandon agriculture during recessions, and lend instead to other sectors of the economy where the profit potential is greater and the credit problems are fewer.

The loan portfolios of System institutions, as single-industry lenders, are concentrated in agricultural commodities. Some of the larger System institutions have successfully diversified the agricultural commodities in their loan portfolios. As of September 30, 2000, however, there were 197 instances at 135 associations where loans to a single commodity exceeded capital. The System lends overwhelmingly to agriculture, which is the sector of the economy that is particularly vulnerable to changes in commodity prices, currency fluctuations, bad weather, diseases, pests, and other difficulties.

The System's market share slipped during the farm crisis of the mid-1980s. During the 1990s the System's market share rose modestly and then leveled off.

Historically, the charters of many System associations have confined their operations to geographic areas where the agricultural economy is dependent on two or three commodities. These geographic barriers make it increasingly difficult for associations to compete. Trade creditors are not subject to geographic limitations, and geographic restrictions on commercial banks have been eased in the past decade. New technology such as e-commerce also expands the geographic markets for lenders and other financial service providers.

Obviously, these commodity and geographic concentrations pose special challenges to the System and the FCA, as its safety and soundness regulator. The System is responding to these challenges. Many System associations have merged, consolidated, or restructured their operations in the past three years. As a result, these associations have become more efficient, which lowers the cost of credit to farmers, improves customer services, and increases the earnings of these borrower-owned institutions. System institutions also have embraced technological innovation and they routinely use the Internet to reach customers.

These changes are good. But more is needed to assure that the System can meet the challenges facing a single-industry lender in an economic environment that is undergoing continual and rapid change.

NATIONAL CHARTER PROPOSED RULE

If the Farm Credit System is to remain a viable source of credit for America's farmers, ranchers, and rural communities, as Congress directed, it must be able to respond to changes in the markets that it serves. This is not a new concern. Our proposed rule on national charters would help the System modernize its credit delivery structure, and at the same time, maintain safe and sound operations.

The national charter rule would end the FCA's practice of generally issuing exclusive territorial charters to direct lender associations. The FCA's authority to grant and amend the charters of System institutions is clear and unambiguous. The courts have reaffirmed this authority on several occasions. With limited exceptions, Farm Credit statutes do not require exclusive charters for System institutions. Instead, the FCA, as a matter of policy and practice, usually issued exclusive charters to direct lender associations. Notwithstanding this fact, the

territories of a number of System associations have overlapped for some time. Overchartering has not posed any safety and soundness concerns.

Historical Background

The Agricultural Credit Act of 1987 encouraged the Farm Credit System to restructure by creating four new types of System institutions -- Farm Credit Banks, agricultural credit banks, Federal land credit associations, and agricultural credit associations. This restructuring led to numerous instances of overlapping territories and competition among associations. This has led to increasing public discussion and debates over whether the FCA should end the policy of exclusive charters for direct lender associations.

Our proposed national charter rule culminates a decade of discussion and debates about how to ensure that the System remains safe and sound, and relevant to the farmers, ranchers, and other rural residents who borrow from it. In May of 1990, the Secretary of the Treasury issued a report on GSEs that recognized that the System faced unusual business risks. This report acknowledged that System charters limited the operation of individual associations to specific geographic regions, causing an institution's "performance [to] rise and fall with the fortunes of a single crop or perhaps with those of a limited number of customers."⁴ Although the Secretary's report made no recommendation about how to best address this problem, it generated much thought, discussion, and debate.

The FCA first raised the question about ending the policy of geographically exclusive charters in 1994 when it asked the public to comment on a proposed Board policy statement on non-exclusive charters.⁵ At other times during the past decade, the FCA has sought comments,

⁴ Report of the Secretary of the Treasury on Government Sponsored Enterprise, May 1990, page D-15.

⁵ 59 FR 17543 (April 13, 1994).

input, and ideas from a wide variety of sources, including the general public, academicians, and policy experts.

In July 1998, the FCA Board issued a Philosophy Statement that, among other things, announced support for abolishing geographic restrictions on System institutions. The first major step in implementing the FCA Board's Philosophy Statement occurred in November 1998, when the FCA published a proposed rule that would have repealed regulations that required notice or consent when a direct lender made or participated in loans in the territory of another association. The Agency received over 200 letters and considerable comments during the 180-day comment period. Reaction was split. The Board suspended action early in 2000 to study the matter further.

In April 2000, the FCA adopted a final rule that repealed the notice and consent requirements that applied when a System institution bought participation interests in loans that a commercial bank made in the chartered territory of another System institution. By repealing these regulations, the FCA Board authorized System institutions to participate in loans that non-System lenders, including commercial and community banks, made to eligible farmers and ranchers anywhere in the United States.

The FCA did not repeal the notice and consent requirements for direct lending. Instead, the Board announced plans on March 8, 2000 to remove geographic barriers by granting national charters to System direct lenders that apply for them. The FCA sent a Booklet to all System institutions on May 3, 2000 that provided guidance on national charters. We also posted this Booklet on our Website. After this initial process, approximately 97 percent of all eligible associations indicated an interest in a national charter.

The Booklet imposed no requirements on System institutions. Instead, it communicated the FCA Board's willingness to accept national charter applications from any direct lender that voluntarily applied for one. Because our National Charter Initiative sparked intense public interest and debate, we published the Booklet in the *Federal Register* in July 2000⁶ and requested comment. We received over 1000 comments about national charters.

However, several parties raised procedural concerns about the Booklet. They believed that the law requires the FCA to pursue a notice and comment rulemaking for national charters. While FCA's legal counsel continues to believe that the Agency may issue or amend charters without conducting a rulemaking, the Board decided to propose a rule. A rulemaking dispels any doubt that this initiative does not comply with applicable administrative procedure laws. Second, a rule will establish strong business planning requirements for any association that applies for and receives a national charter. Third, a rule requires associations that request and receive a national charter to comply with existing FCA regulations that impose strong and enforceable capital, loan underwriting, and internal control requirements on all System institutions.

Before I describe our proposed national charter rule to you in greater detail, I want to reiterate that the ideas expressed in this proposal are not new. Indeed, the FCA, the System, commercial banks and their trade associations, academicians, and policy experts have debated the removal of geographic restrictions of System associations for several years.

The FCA Board adopted the proposed rule on January 11, 2001, and sent it to the House and Senate agriculture committees for a 30-day review. The proposed rule was published in the *Federal Register* on February 16, 2001 for a 30-day comment period. I want to assure you that

⁶ 65 FR 45066 (July 20, 2000).

the FCA will seriously consider and carefully weigh all substantive comments that we receive about the proposed national charter rule.

Criteria for National Charters

The proposed rule would establish clear standards so direct lender associations may apply for, receive, and operate safely and soundly under a national charter. A national charter authorizes a direct lender association to exercise all powers conferred on it under the Farm Credit Act and FCA regulations throughout the United States and the Commonwealth of Puerto Rico or within any lesser territory that the FCA specifies.

National charters will not initially include the territories of certain associations that currently operate in Alabama, Mississippi, New Mexico and parts of Louisiana. The statute requires the shareholders of these associations, their funding banks, and in some cases, their boards of directors to consent before the FCA can add their territory to the charter of any other System institution. The FCA initiated a separate rulemaking so the farmers and ranchers who own the associations in these four states will have the opportunity to vote on whether to allow other associations to serve their territories.⁷

No direct lender association that is under a cease and desist order that has become final is eligible to request a national charter. Once an association receives a national charter, the FCA reserves the right to restrict the association's operations if it fails to operate safely and soundly.

Each association that receives a national charter will be assigned a Local Service Area (LSA). For existing associations, the LSA is the territory that they served immediately before they obtained a national charter. Under the proposed rule, each association with a national charter must offer credit and related services in its LSA. Additionally, the LSA requirement will

⁷ 65 FR 26776 (May 9, 2000); 65 FR 58486, (Sept. 29, 2000).

ensure that the System, as a whole, carries out its public policy mission of extending credit and related services to farmers, ranchers, and other eligible customers in every part of the United States. Therefore, each association with a national charter must provide dependable, sound, adequate, competitive, and constructive credit and related services to all eligible and creditworthy customers within its LSA on a priority basis, consistent with safe and sound lending practices. The FCA expects each nationally chartered association to make special efforts to serve young, small, and beginning farmers in its LSA.

The proposed rule establishes the procedures that each association must follow when it applies for a national charter. Additionally, each association that obtains a national charter must comply with new regulatory business planning requirements. At a minimum, an acceptable business plan must include:

- A mission statement;
- Internal and external factors that are likely to affect the association during the planning year;
- Quantifiable goals and objectives;
- Pro forma financial statements for each year of the plan;
- An operating budget
- A capital adequacy plan; and
- A detailed plan for activities in the LSA

These business plans must be updated every year.

Each nationally chartered association must comply with statutes and regulations that govern capital adequacy, loan underwriting and servicing requirements, internal controls, consumer protection, equal credit opportunity, and fair lending practices. Additionally, the FCA

will allow only direct lender associations that operate in accordance with capital, assets, management, earnings, liquidity, interest rate sensitivity, and other safety and soundness standards to lend and offer related services nationally.

CONCLUSION

In conclusion, Mr. Chairman, the Farm Credit System must meet the challenges of a rapidly changing agricultural economy and achieve its mission of providing sound, dependable, and affordable credit to farmers, ranchers, and their cooperatives in both good times and bad. The System has made significant progress in building and maintaining its financial strength in the past decade so it can better serve its customers. However, the pace of change in the rural economy is quickening, and the System must remain ever vigilant if it is to remain relevant to farmers. Improving geographic diversity and reducing industry concentration in System loan portfolios is essential for mitigating safety and soundness risks. The FCA Board believes that the proposed rule on national charters ensures that the System remains a dependable source of credit for farmers in a competitive and rapidly changing economy.

I thank you for the opportunity to address this committee about the challenges facing both the FCA and the System and to explain to you the proposed rule on national charters. I would be pleased to answer any questions at this time.